EDISON

paragon

Risk reduction should relieve the equity rating

Disposal and early bond redemptions

Automobiles and parts

paragon appears to be progressively de-risking its investment proposition. The agreed sale of Semvox crystallises an enterprise value (EV) that highlights the depressed market cap due to the debt burden. The accelerated redemption of the entire Swiss franc (CHF) bond issue and half the Eurobond reduces debt metrics to typical industrial levels, and we expect improving cash flows to facilitate final redemption in 2027. The result is an apparently anomalous rating for paragon compared to its estimated cash valuations and peers. Assuming the disposal completes and the bonds are redeemed as anticipated, the crushed equity value of recent years should finally be relieved.

Year end	Revenue (€m)	PBT* (€m)	EPS* (€)	DPS (€)	P/E (x)	Yield (%)
12/20**	127.2	(6.0)	0.79	0.0	5.8	N/A
12/21	146.9	1.2	0.27	0.0	16.9	N/A
12/22e***	160.1	(1.9)	(0.38)	0.0	N/M	N/A
12/23e	173.5	4.6	0.74	0.0	7.1	N/A
12/24e	195.6	9.1	1.22	0.0	4.3	N/A

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles and exceptional items. **Restated following Voltabox sale. ***paragon semvox discontinued from FY22e.

Trading momentum remains positive

paragon has announced that FY22 revenues for continuing activities rose 18% to €160.1m, ahead of guidance for €156.5m. paragon semvox (Semvox), the Digital Assistance business unit that is being sold and is to be treated as discontinued in FY22 accounts, generated sales of €12.8m. The positive sales momentum continued into the current year, with January revenues 29% ahead of the prior year at €14.6m. Although earnings have yet to be disclosed, we suspect that Semvox would generate above group average returns, so the ongoing EBITDA margin was likely below 15%, a level still consistent with previous management guidance.

Semvox sale facilitates early bond repayments

The €40m sale of Semvox announced in December should complete in Q223. The proceeds should be applied to fully redeeming the CHF21m 4% bond maturing on 23 April 2023, as well as early redemption of half the €50m 6.75% 2027 Eurobond in line with the extension terms agreed last year. Management has already bought back CHF8.4m through a tender offer in January, and on 6 February 2023 launched a repurchase programme for up to €5m of the Eurobond. The resulting reduction in debt to more typical levels should reduce finance charges by over €3m annually and allow management to focus on the growth plan for the ongoing activities.

Valuation: Risk discounts should moderate

The debt retirement should alleviate much of the risk discount applied to paragon. Even before the EPS enhancement from the interest savings, the low single-digit FY24 P/E multiple looks anomalous. In addition, the disposal should generate a c €15m profit while crystallising a substantial proportion of group EV. The lower financial risk bolsters cash-based valuations.

10 February 2023

Price	**€5.26**
Market cap	**€24m**

Adjusted net debt (€m) at 30 September 2022 (excludes leases €12.7m)	89.6
Shares in issue	4.5m
Free float	50.7%
Code	PGN
Primary exchange	Frankfurt Xetra
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	22.3	17.4	(16.2)
Rel (local)	16.6	3.4	(16.5)
52-week high/low		€6.24	€3.65

Business description

Based in Delbrück, Germany, paragon designs and supplies automotive electronics and solutions, selling directly to OEMs, including sensors, interior, body kinematics and power. It has production facilities in Germany, Croatia and China.

Next events

Swiss bond final	23 April 2023
FY22 results	26 April 2023
Q123 results	12 May 2023

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Semvox sale to financially underpin prospects

On 1 December 2022, paragon announced an agreement to sell its paragon semvox subsidiary (Semvox) to CARIAD, a software subsidiary of the Volkswagen Group, for c €40m. Semvox formed the digital assistance business unit of paragon. The deal is expected to complete by the end of April 2023, but there is a risk it could be delayed as it is contingent on several antitrust approvals. However, these are not considered by management to be likely to lead to delays given the scale of the business.

Adjusting earnings to treat Semvox as discontinued

Following the agreement, Semvox will be treated as a discontinued business from FY22. As a result, on 5 December 2022 paragon's management updated guidance for FY22 and FY23 as well as providing a new five-year outlook to 2027.

In a release on 6 February 2023, management indicated that Semvox generated €12.8m in 2022. As a result of its disaggregation, paragon's FY22 revenue from its continuing business was €160.1m, an increase of 18.2%, beating December 2022 guidance of €156.5m. While not explicitly disclosed to date, we expect the FY22 EBITDA margin for the continuing business to be reduced to less than 15% as Semvox appears to have been achieving higher than average EBITDA margins. In 2021 it achieved net income of €2.6m.

For FY23, revenue guidance was maintained at €170m and while implying slower growth than the c 10% previously indicated, this may be conservative. Management highlighted January 2023 revenues of €14.6m for the ongoing activities being 29% ahead of January 2022. We assume Semvox's revenue growth was expected to be above the group rate. We think the new EBITDA margin guidance for the continuing paragon activities of 12–15% reflects an element of adverse business mix as new lower-margin contracts ramp up.

We have reduced our FY22 and FY23 earnings estimates to reflect the revised guidance and introduce our FY24 estimates.

Exhibit 1: Revisions to paragon earnings estimates (Semvox discontinued)

Year to December (€m)	2022e	2022e		2023e	2023e		2024e
	Prior	New	*Change*	Prior	New	*Change*	New
Electronics	120.6	107.9	*-10.6%*	133.9	118.7	*-11.4%*	136.5
Mechanics	50.2	52.2	*4.0%*	54.2	54.8	*1.1%*	59.2
Total group revenues	**170.8**	**160.1**	***-6.3%***	**188.1**	**173.5**	***-7.8%***	**195.6**
Electronics	21.7	15.1	*-30.5%*	25.4	19.6	*-23.1%*	23.2
Mechanics	4.0	2.1	*-48.0%*	5.4	3.3	*-39.3%*	4.7
HQ Other and intersegment	0.2	0.2	*8.7%*	0.2	0.2	*8.7%*	0.2
EBITDA (pre PPA amortisation)	**25.9**	**17.4**	***-32.9%***	**31.0**	**23.1**	***-25.7%***	**28.1**
Underlying PBT continuing	**2.9**	**(1.9)**	***N/M***	**7.4**	**4.6**	***-37.5%***	**9.1**
EPS – underlying continuing (€)	**0.47**	**(0.38)**	***N/M***	**1.19**	**0.74**	***-37.6%***	**1.22**
DPS (€)	0.0	0.0		0.0	0.0		0.0
Adjusted net cash/(debt)	(89.0)	(88.9)	*-0.2%*	(83.8)	(84.1)	*0.3%*	(82.3)

Source: Edison Investment Research estimates

Five-year outlook also updated for continuing business

Management also updated its five-year outlook to FY27 (FY26 previously), again reflecting the agreed disposal of Semvox. It nevertheless expects revenues to almost double to more than €300m, a compound annual growth rate of around 14% over the five-year period. The previous longer-term guidance was for FY26 revenues of €250–300m with EBITDA margins of 20%. The revision in part reflects the elimination of growth at Semvox, but nevertheless represents a strong progression by the continuing businesses, especially in the recently created power business unit.

In our model, our FY27 revenue estimate is significantly below €300m.

The financial impact of selling Semvox

The numbers above are adjusted to reflect the performance of the continuing paragon automotive activities, but do not reflect the actual impact of completing the disposal of Semvox. As is normal practice, we only adjust for M&A transactions when deals are completed. Therefore, Semvox's assets are still consolidated as held for sale current assets, net debt does not reflect the receipt of the disposal cash proceeds, with earnings and cash flows still consolidated as discontinued items.

On completion, the company should receive the c €40m cash proceeds and, as discussed below, these should be applied to substantial bond redemptions, with a major benefit to the net interest charge in FY23 and the future. Net debt should fall to around €42m (€89.6m at end-September 2022), of which only around $25m would be the outstanding 2027 6.75% Eurobond issue.

The result is that while continuing revenues and operating profits remain the same, PBT, net income and thus EPS should be significantly enhanced by the lower interest charges. We estimate the disposal should generate an exceptional profit on disposal of around €15m. We assume completion around the end of April 2023.

The financial benefits should notionally benefit our current estimates approximately as follows:

Exhibit 2: Potential impact on Edison's paragon earnings estimates (assuming Semvox disposal completed)

Year to December (€m)	2023e	2023e		2024e	2024e	
	Current estimates	On disposal completion	Change	Current estimates	On disposal completion	Change
Electronics	118.7	118.7	0.0%	136.5	136.5	0.0%
Mechanics	54.8	54.8	0.0%	59.2	59.2	0.0%
Total group	**173.5**	**173.5**	**0.0%**	**195.6**	**195.6**	**0.0%**
Electronics	19.6	19.6	0.0%	23.2	23.2	0.0%
Mechanics	3.3	3.3	0.0%	4.7	4.7	0.0%
HQ Other and intersegment	0.2	0.2	0.0%	0.2	0.2	0.0%
EBITDA (pre PPA amortisation)	**23.1**	**23.1**	**0.0%**	**28.1**	**28.1**	**0.0%**
Underlying PBT	**4.6**	**5.8**	**25.9%**	**9.1**	**12.0**	**32.5%**
EPS - underlying continuing (€)	**0.74**	**0.93**	**25.9%**	**1.22**	**1.70**	**38.9%**
DPS (€)	0.0	0.0		0.0	0.0	
Net cash/(debt)	(84.1)	(42.4)	-49.6%	(82.3)	(38.0)	-53.9%

Source: Edison Investment Research estimates

With notional FY23 EPS of €0.93 per share, the P/E multiple of 5.0x is not demanding, and falls sharply to just 2.7x in FY24. In addition, net debt to EBITDA should fall to 1.83x in FY23 and 1.35x in FY24, confirming the alleviation of the debt burden.

Early bond redemptions

On 10 January 2023 paragon launched a tender offer up to CHF10m nominal value of its CHF21m 4% bonds due for redemption in April 2023 (ticker: PAR19) issued in 2019. The offer was at 92.5% of the bonds' par value. The offer period ended at midday (CET) on 27 January 2023, at which time paragon had bought back a total nominal amount of CHF8.433m of the PAR19 bonds, leaving

CHF12.567m outstanding. With the Swiss franc/euro exchange rate at parity (CHF1:€1) settlement on 31 January 2023 (including 278 days accrued interest) should cost paragon around €8.1m.

Final redemption at par of the outstanding nominal is due on 23 April 2023.

In the 6 February 2023 announcement, management indicated it has launched a tender offer scheme for up to €5m nominal of the Eurobond that would run until 3 March 2023.

The agreed disposal of Semvox should trigger the accelerated repayment of all €25m of the interim redemption tranches of the €50m 6.75% 2027 Eurobond agreed on the extension last year. As a reminder, the early redemption schedule for half the outstanding bonds was in three tranches: €5m in 2023, €10m in 2025 and a further €10m in 2026. All become due on completion of the potential M&A project, which is Semvox. We assume the announced buyback scheme should offset the 2023 commitment. With the bonds currently trading at around 65% of the nominal value, the total early redemption might be achieved for a total cash cost of c €16m.

The outstanding €25m repayable on final maturity in 2027 would then be the only major financial liability carried by paragon, and the annual interest payable would reduce by c €3.1m (including CHF bond interest and 2.5% PIK[1] interest on the Eurobond). Together with bank borrowings, the net debt to EBITDA ratio (the net leverage ratio) in FY23 would be just 1.83x, which would be in line with acceptable levels for similar industrial companies for the first time in many years. It should in turn lead to lower interest rates on the outstanding Eurobond as a reduction in the leverage ratio is a key factor in its adjustment. The cash interest payable would reduce as the net leverage ratio declines as follows: 6.50% if it falls below 4.0x at the last balance sheet date, 6.25% if it falls below 3.5x, 5.50% below 3.0x and 5.00% below 2.5x. With an expected improvement in net cash flow as the ongoing business grows revenues and margin, the leverage ratio should reduce further in subsequent years.

As a result of the proposed Semvox disposal, management has secured bridge finance that should cover both the early redemption payments and the final redemption of the PAR19 CHF bonds. The bridging facility will be paid down when the c €40m proceeds for the sale are received in Q223.

Valuation

The deleveraging of paragon should have a positive impact on the risk assessment for the group, and thus on the cost of capital. In turn that boosts discounted cash flow (DCF) valuations for the group, underlining our previous view that paragon's equity is adversely affected by the historical debt burden and more specifically the bond maturities. More normal industrial and automotive ratings metrics should then also be applied to the group.

The only significant outstanding issues that need clarification would appear to be the unanticipated circumstances surrounding the founders' shareholding in the listed entity and the timing of a return to dividend payments in the future, which are currently restricted by the terms on the Eurobond until fully redeemed in 2027.

Our capped DCF has been rolled forward on an FY23 basis and now stands at €26.6 per share (previously €19.8 per share in August 2022 on an FY22 basis), adjusting for the discontinuation of Semvox by eliminating its cash flow and as an equivalence reducing net debt used for the calculation by the anticipated €40m proceeds. The calculation is still based on a 15% cost of equity but that should reduce as the bonds are redeemed and risk is alleviated. The resultant current WACC of 8.0% will benefit from lower risk levels, but as the debt funding reduces as a proportion of the EV there will be an offsetting upwards tendency towards the still higher cost of equity.

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1 PIK – payment in kind, a type of incremental interest payment.

Exhibit 3: paragon capped DCF sensitivity to WACC and terminal growth rate (€/share)

WACC	6.0%	6.5%	7.0%	7.5%	8.0%	8.5%	9.0%	9.5%	10.0%
Terminal value									
0%	42.7	37.8	33.6	30.0	**26.6**	23.9	21.4	19.3	17.3
1%	43.2	38.2	34.0	30.3	26.9	24.2	21.7	19.5	17.6
2%	43.6	38.6	34.3	30.6	27.2	24.4	22.0	19.8	17.8
3%	44.1	39.0	34.7	31.0	27.6	24.7	22.2	20.0	18.0

Source: Edison Investment Research estimates

While the jump in valuation may seem surprising, it should be noted that we have slightly increased our forecasts for the ongoing businesses following the better-than-expected trading in FY23 and we also start with a reduced level of net debt in the calculation, following FY22 estimated debt reduction that adds around €3.3 per share.

The €26.6 per share DCF value would be a multiple of 15.6x our notional post disposal FY24 EPS estimates (Exhibit 2). While this might look ambitious today, we feel that such a multiple could increasingly be supported by fundamental metrics, as ongoing debt reduction reduces risk.

It is worth noting that the agreed disposal of Semvox will crystallise an EV of around €40m for a small part of the group (around 8% of sales and 20% of EBITDA). That compares to the current group EV of just over €110m.

As the debt reduction should substantially de-risk paragon, we would expect a further re-rating to be plausible as the growth strategy for the ongoing activities is executed over the next five years.

Exhibit 4: Financial summary

€m	2020*	2021	2022e**	2023e	2024e
Year end December	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	127.2	146.9	160.1	173.5	195.6
Cost of Sales	(69.2)	(72.6)	(75.2)	(79.8)	(88.0)
Gross Profit	58.0	74.4	84.8	93.7	107.6
EBITDA	13.8	20.0	17.4	23.1	28.1
Operating Profit (before amort. and except).	6.6	13.3	10.3	14.1	18.6
Intangible Amortisation	(6.0)	(6.0)	(4.4)	(2.5)	(2.8)
Exceptionals	(11.2)	(6.5)	(7.1)	(4.0)	(4.0)
Other	0.0	0.0	0.0	0.0	0.0
Operating Profit	(10.6)	0.8	(1.3)	7.6	11.8
Net Interest	(6.5)	(6.1)	(7.8)	(7.0)	(6.8)
Profit Before Tax (norm)	(6.0)	1.2	(1.9)	4.6	9.1
Profit Before Tax (FRS 3)	(17.2)	(5.3)	(9.0)	0.6	5.1
Tax	9.6	(0.2)	0.5	(1.2)	(2.5)
Discontinued	(37.1)	(5.9)	3.0	1.0	0.0
Profit After Tax (norm)	3.6	1.2	(1.7)	3.4	5.5
Profit After Tax (FRS 3)	(44.7)	(11.4)	(5.5)	0.3	2.6
Average Number of Shares Outstanding (m)	4.5	4.5	4.5	4.5	4.5
EPS - normalised (€)	0.79	0.27	(0.38)	0.74	1.22
EPS - normalised fully diluted (€)	0.79	0.27	(0.38)	0.74	1.22
EPS - (IFRS) (€)	(9.87)	(2.52)	(1.22)	0.08	0.58
Dividend per share (€)	0.00	0.00	0.00	0.00	0.00
Gross Margin (%)	45.6	50.6	53.0	54.0	55.0
EBITDA Margin (%)	10.8	13.6	10.9	13.3	14.4
Operating Margin (before GW and except.) (%)	5.2	9.1	6.4	8.1	9.5
BALANCE SHEET					
Fixed Assets	143.1	115.0	68.6	66.7	67.0
Intangible Assets	81.5	76.4	41.2	39.2	37.3
Tangible Assets	47.0	36.2	24.6	24.6	26.9
Right of use asset	13.1	1.8	2.3	2.3	2.3
Investments	1.5	0.6	0.6	0.6	0.6
Current Assets	57.4	44.7	68.3	68.7	71.7
Stocks	27.3	24.0	24.0	24.7	26.5
Debtors	11.6	10.9	10.4	10.3	10.5
Cash	5.7	1.5	1.5	1.5	1.5
Other	12.7	8.4	32.5	32.3	33.3
Current Liabilities	(90.6)	(125.5)	(32.2)	(35.0)	(37.6)
Creditors	(41.3)	(31.9)	(32.2)	(35.0)	(37.6)
Short term borrowings	(49.3)	(93.6)	0.0	0.0	0.0
Long Term Liabilities	(96.6)	(30.9)	(107.0)	(102.2)	(100.5)
Long term borrowings	(67.6)	(10.2)	(90.3)	(85.5)	(83.8)
Lease liabilities	(18.7)	(12.1)	(10.1)	(10.1)	(10.1)
Other long term liabilities	(10.4)	(8.6)	(6.6)	(6.6)	(6.6)
Net Assets	13.2	3.3	(2.2)	(1.9)	0.7
CASH FLOW					
Operating Cash Flow	11.6	19.8	19.2	24.6	26.7
Net Interest	(6.5)	(6.1)	(7.8)	(7.0)	(6.8)
Tax	9.6	0.0	0.2	(1.2)	(3.5)
Capex	(7.7)	(17.5)	(8.2)	(11.5)	(14.7)
Acquisitions/disposals	0.0	8.4	0.0	0.0	0.0
Financing	1.9	6.5	10.0	0.0	0.0
Dividends	0.0	0.0	0.0	0.0	0.0
Net Cash Flow	8.9	11.1	13.5	4.8	1.8
Opening net debt/(cash)	117.4	111.2	102.3	88.9	84.1
HP finance leases initiated	0.0	0.0	0.0	0.0	0.0
Other	(2.7)	(2.2)	(0.0)	(0.0)	(0.0)
Closing net debt/(cash) (excluding leases)	111.2	102.3	88.9	84.1	82.3
Total financial liabilities	130.0	114.4	98.9	94.1	92.4

Source: Company reports, Edison Investment Research estimates. Note: *FY20 restated following Voltabox sale. **paragon semvox treated as discontinued from FY22e.

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